

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
LANSBOT-ARLEN FABRICS, INC.	:	DETERMINATION
	:	DTA NO. 815264
for Redetermination of a Deficiency or for Refund of	:	
Corporation Franchise Tax under Article 9-A of the	:	
Tax Law for the Period October 1, 1990 through	:	
September 30, 1992.	:	

Petitioner, Lancot-Arlen Fabrics, Inc., 295 Fifth Avenue, New York, New York 10016-7103, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the period October 1, 1990 through September 30, 1992.

Petitioner, by its representative, Edward A. Berlin, Esq., and the Division of Taxation by Steven U. Teitelbaum, Esq. (Kenneth J. Schultz, Esq., of counsel), executed a consent to have the controversy determined on submission without hearing. Documents and briefs were submitted by both parties. Petitioner submitted a reply brief on December 12, 1997 which date began the six-month period for issuance of this determination. Upon review of the documents and briefs, Jean Corigliano, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation properly allocated petitioner's income from government and corporate debt instruments by application of petitioner's business allocation

percentage where its investment allocation percentage was zero and the debt instruments were payable on demand within six months and one day from the date on which the debt was incurred.

II. Whether the debt obligation of a third party, incurred to settle a claim for conversion of goods, qualifies as investment capital.

III. Whether, if the tax deficiency at issue is sustained, petitioner has established that its failure to report and pay the tax due was due to reasonable cause.

FINDINGS OF FACT

1. Petitioner, Lancot-Arlen Fabrics, Inc., and the Division of Taxation (“Division”) entered into a stipulation of facts. The stipulated facts have been adopted and incorporated into these findings of fact. They have been supplemented with facts taken from the affidavit of Glenda Kirby who is president of Lancot-Arlen Fabrics, Inc. and documents submitted by the parties.

2. Petitioner is a North Carolina corporation which does business and maintains an office in New York City. It timely filed a 1990 New York general business corporation franchise tax report for the period October 1, 1990 through September 30, 1991 (the “1991 fiscal year”) and a 1991 corporation tax report for the period October 1, 1991 through September 30, 1992 (the “1992 fiscal year”).

3. During the 1991 and 1992 fiscal years, petitioner conducted business through two separate operating divisions. One division, headquartered in North Carolina, consisted of a multi-state trucking operation with a small terminal operation located on sub-leased property in New Jersey. The other division consisted of a textile business with manufacturing operations located in North Carolina and sales, administrative and other general functions located in New York City.

4. In addition to operating these divisions, petitioner maintained a portfolio of U.S. Treasury and other obligations. As of October 1, 1990, the value of petitioner's portfolio was \$19,624,822.00, consisting of U.S. Treasury obligations of \$19,524,822.00 and a single \$100,000.00 commercial paper investment with a maturity of six months or less. As of September 30, 1992, the value of petitioner's portfolio was \$26,697,991.00, consisting entirely of U.S. Treasury obligations. Except for certain commercial paper investments and a repurchase agreement which involved commercial paper, the composition of the portfolio throughout the period in issue consisted of short-term U.S. Treasury obligations. All of the investments described here had maturities of six months or less.

5. Petitioner's portfolio of U.S. Treasury obligations and commercial paper was managed by First National Bank of Boston, located in Boston, Massachusetts, and Wachovia Bank of North Carolina, located in Winston-Salem, North Carolina. The offices handling the investment account at each of these financial institutions were located outside of New York. Pursuant to petitioner's standing instructions, U. S. Treasury obligations were purchased. On occasion, short-term commercial paper or a repurchase agreement involving commercial paper was purchased. The accounts maintained by petitioner for its investment activity were separate from other accounts maintained for its business operations.

6. During the 1991 and 1992 fiscal years, petitioner was owed funds by an unrelated third-party supplier, Wilmington Finishing Co. ("Wilmington"). This obligation arose out of a settlement of petitioner's claims relating to the party's alleged damage and conversion of petitioner's property. The obligation was repaid to petitioner, with interest, over a period which

ended in March 1993 and included the 1991 and 1992 fiscal years. In a letter dated November 16, 1990, Wilmington's president described the character of the debt and the repayment agreement as follows:

This letter is to acknowledge that the prior management of Wilmington Finishing Company misappropriated greige goods owned by Lancot-Arlen Fabrics, Inc. and as a consequence, Wilmington Finishing Company is indebted to Lancot-Arlen Fabrics, Inc.

Our best estimate at the present time is that this debt totals \$1,520,834.47. We anticipate that we will have completed our final inventory of the misappropriation by early January, at which time we will agree to the final total of this debt.

Per our discussions, this debt will be repaid in full, dollar for dollar, at 6 percent interest per annum on the unpaid balance, with payments based on the invoices we sent to Lancot-Arlen. This debt is to be repaid by refunding 6 percent of the amount paid by Lancot to us commencing October 22, 1990. We will continue to repay under this arrangement until the entire debt is repaid.

7. Petitioner's liabilities as of October 1, 1990 consisted of ordinary-course-of-business accounts payable, accrued expenses and the balance due on a note payable in one year or more with an original principal amount of \$3,800,000.00. The indebtedness on the note payable was incurred in connection with the redemption of a former stockholder's interest in petitioner. This indebtedness was satisfied out of proceeds generated from business operations. Overall business operations produced additional cash proceeds resulting, in part, in increases to petitioner's investment portfolio during the audit period.

8. Petitioner's liabilities as of September 30, 1992 consisted of ordinary-course-of-business accounts payable, accrued expenses and a mortgage, note or bond payable within one year. These liabilities totaled \$9,234,917.00 as of October 1, 1990 and \$6,568,460.00 as of September 30, 1992. The book value of petitioner's assets as reported on its tax returns was \$60,248,500.00 as of October 1, 1990 and \$67,055,500.00 as of September 30, 1992. Thus,

petitioner's portfolio of investments in Federal and corporate obligations represented approximately 40 percent of the book value of all of its assets as of the end of the audit period.

9. Except for certain distributions to stockholders made in light of petitioner's S corporation status, income from petitioner's investment portfolio was reinvested in like instruments. Because petitioner was an S corporation for Federal (and certain state) income tax purposes, petitioner's stockholders were subject to Federal tax (and certain state taxes) on all of its taxable income.

10. Although petitioner invested in short-term obligations, its overall investment program was of a long-term nature and was not predicated on working capital requirements of the business operations. Petitioner's business operations were profitable throughout the audit period and were able to sustain themselves without the need for borrowing from the investment portfolio.

11. On its 1990 and 1991 corporation franchise tax reports, petitioner listed U.S. Treasury obligations and commercial paper as its only investment capital. For the 1992 fiscal year, petitioner reported its income from the U.S. Treasury obligations as investment income. For the 1991 fiscal year, petitioner reported its income from the U.S. Treasury obligations and commercial paper as investment income. Petitioner's investment allocation percentage was zero for both its 1991 and 1992 fiscal years. Petitioner reported other miscellaneous interest income as business income for both of its fiscal years.

12. For the 1992 fiscal year, the Division determined petitioner's income by treating all of the income from the U.S. Treasury obligations as business income. For the 1991 fiscal year, the Division redetermined petitioner's income by treating all of the income from the U.S. Treasury

obligations and commercial paper as business income. Petitioner's business income allocation percentage was greater than zero for both fiscal years.

13. In determining petitioner's income, the Division applied section 3-3.2(a)(1) of the corporation franchise tax regulations¹ and in accordance with that regulation deemed petitioner's portfolio of short-term debt instruments to be "cash" on the basis that the maturity dates were less than six months and one day. The Division then determined that petitioner had no other investment capital during the audit period and by operation of a second provision of the same regulation could not elect to treat cash as investment capital. Consequently, the Division applied petitioner's business allocation percentage to the income from its investment portfolio in allocating petitioner's income.

14. As a result of the Division's determination regarding the nature of petitioner's investments, the Division issued a Notice of Deficiency to petitioner, dated May 3, 1995, asserting a tax deficiency of \$43,487.00 for the period October 1, 1989 through September 30, 1992, plus penalty and interest. Of the total amount of tax asserted, \$1,396.00 was attributable to the fiscal year ended September 30, 1990. Petitioner paid this latter amount plus applicable interest; therefore, this portion of the notice is not in dispute.

15. Petitioner requested a conciliation conference to contest the tax, penalty and interest asserted by the Division for the 1991 and 1992 fiscal years. A conference was conducted on February 7, 1996, and a Conciliation Order, dated May 17, 1986, was issued sustaining the Notice of Deficiency. The Conciliation Order notes, however, that a payment of \$61,552.00 was

¹The regulations in effect during the audit period, 20 NYCRR former 3-4.2, effective for tax years beginning on or after January 1, 1989, were amended and renumbered as 20 NYCRR 3-3.2, effective October 27, 1993. Inasmuch as the amendments do not relate to the issues in this proceeding, all references in this determination will be to the current regulation unless otherwise specified.

made by petitioner and applied to amounts shown due on the statutory notice. Petitioner's payment consisted of tax in the amount of \$42,091.00 for the 1991 and 1992 fiscal years, plus penalty of \$3,680.00 and interest of \$15,781.00 calculated through April 26, 1996.

16. Petitioner then filed a petition for a redetermination of the tax deficiency, cancellation of all penalties and for refund of the tax paid minus the amount conceded by petitioner for the 1990 fiscal year.

SUMMARY OF THE PARTIES' POSITIONS

17. Petitioner maintains that allocating income from its investments in short-term Federal and corporate obligations by its business allocation percentage is unreasonable and leads to distortion of its New York income, and it argues that under these circumstances the Commissioner should exercise the authority granted him by Tax Law § 210(8) to vary the statutory formula to reflect a fair and proper allocation of income.² This argument is premised primarily on petitioner's assertion that its investments cannot rationally be viewed as cash. Its position is capsulized in its brief as follows:

[g]iven the largely elective regime available for cash investments generally, and the fact that the investments of Taxpayer in question were in fact the result of separate, substantial investment activities, the Department's attempt to recast such investments as cash on deposit incidental to Taxpayer's business operations is unreasonable and results in a distortion warranting discretionary adjustment. Taxpayer should be entitled to treat the income from its U.S. Treasury and other obligations as income from investment capital, consistent with its intentions and the substance of its activities, [sic] during the Audit Period.

If a discretionary adjustment is found not to be warranted by the facts of this case, then petitioner argues that application of the Division's regulations is inconsistent with the plain

²Article 9-A of the Tax Law was amended several times during and since the tax period in issue. Except where necessary to discuss substantive amendments affecting the outcome of this proceeding, all references are to the current statute.

language of the statute and requires a finding that the regulations, as applied to petitioner's income, are invalid.

Finally, petitioner asserts that it had investment capital in addition to its portfolio of short-term obligations, namely the debt owed by an unrelated third-party corporation, and, therefore, that it was free under the regulations to elect to treat cash on hand as investment capital. In addition to these arguments, petitioner seeks cancellation of all penalties on the basis that reasonable cause existed for the understatement of any tax due.

18. The Division's position is that it correctly applied its regulations to the income generated by petitioner's investments in short-term obligations. In this regard, the Division contends that section 3-3.2(a)(1) of the regulations deeming short-term debt instruments to be "cash on hand or on deposit" is a rational interpretation of section 208(7) of the Tax Law which the regulation implements. The Division argues that petitioner has failed to show entitlement to a discretionary adjustment because it has not shown that application of the business allocation percentage to income from petitioner's investments in Federal and corporate obligations results in taxation of income which has no connection to New York State. The Division disputes petitioner's claim that debt owed to petitioner by a third party constitutes investment capital. The Division claims that petitioner has failed to demonstrate reasonable cause sufficient to warrant the abatement of penalties.

CONCLUSIONS OF LAW

A. New York State imposes an annual franchise tax on all corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in the State (Tax Law § 209[1]). The tax is computed by whichever of four alternative methods results in the greatest tax (Tax Law § 210[1][c]). The method used by

petitioner consists of a tax on entire net income base. The entire net income base is the portion of its entire net income allocated to New York State by the application of a statutory formula which allocates corporate income depending upon the connection between that income and the State (Tax Law § 210[1][a]). The portion of a taxpayer's business income allocated to the State is determined by multiplying the taxpayer's total business income by a business allocation percentage or "BAP" (Tax Law § 210[3][a]). The BAP is determined by reference to the proportion of the taxpayer's payroll, property and receipts attributable to New York compared to those of the corporation as a whole (Tax Law § 210[3][a]). A taxpayer's investment income is allocated to the State by multiplying its total investment income by an investment allocation percentage, or "IAP" (Tax Law § 210[3][b]). The IAP calculation begins with the computation of a fraction. The numerator of the fraction is the combined allocated fair market value of all corporate obligations held by a taxpayer. The denominator is the taxpayer's total investment capital. (Tax Law § 210[3][b][1],[2],[3].) "The taxpayer's IAP reflects the degree of State presence of the issuers of the securities in which the taxpayer has invested, while the taxpayer's BAP reflects the taxpayer's own activities in the State" (*Matter of Allied-Signal v. Tax Appeals Tribunal*, 229 AD2d 759, 645 NYS2d 895).

For the purpose of classifying entire net income, investment income means "income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income" (Tax Law § 208[6].) Investment capital is defined as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business . . ." (Tax Law § 208[5]), and business income means net income minus investment income (Tax Law § 208[8]) .

In this instance, the Division properly applied the regulations applicable to the allocation of business and investment capital. The plain language of section 208(5) and of the regulations interpreting that statute establish that investments in state and Federal obligations, like U.S. Treasury bonds, are properly categorized as investment capital as are investments in certain corporate debt instruments.³ Section 3-3.2(a)(1) of the Division's regulations provides that any debt instrument described in 20 NYCRR 3-3.2(c)(2) and 20 NYCRR 3-3.2(c)(3), essentially any government or corporate debt instrument, "which is payable by its terms on demand or within six months and one day from the date on which the debt was incurred is deemed to be cash on hand or on deposit." Application of this provision required the Division to deem petitioner's investment portfolio as "cash on hand".

Both the Tax Law and the regulations provide that "cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect" (Tax Law § 208[7][a]; *see also*, 20 NYCRR 3-3.2[a][1]). However, this election provision is qualified by 20 NYCRR 3-3.2(a)(1) which states that "[n]o election to treat cash as investment capital may be made where the taxpayer has no other investment capital." Inasmuch as petitioner reported no investment capital other than the short-term debt instruments, it was required by this provision to treat cash (the amounts in its investment portfolio) as business capital and to allocate income from the investment portfolio by its business allocation percentage.

Where it appears that the IAP calculated in accordance with the statutory formula does not accurately reflect a taxpayer's business activity in New York State, the Commissioner is

³20 NYCRR 3-3.2(c) states that for purposes of classifying assets as investment capital the phrase "stocks, bonds and other securities" includes: "debt instruments issued by the United States, any state, territory or possession of the United States, the District of Columbia, or any foreign country, or any political subdivision or governmental instrumentality of any of the foregoing" (20 NYCRR 3-3.2[c][2]) and "qualifying corporate debt instruments" (20 NYCRR 3-3.2[c][2]).

authorized, in his discretion, to adjust the formula “by excluding one or more assets in computing such percentage provided the income therefrom is also excluded in determining entire net income or maximum taxable income” (Tax Law § 210[8]).

B. At the Division’s suggestion, the third issue raised by petitioner, whether petitioner had investment capital in addition to U.S. Treasury obligations and commercial paper, will be addressed first, since adoption of petitioner’s position on this issue will render the other issues moot. Petitioner claims that Wilmington’s debt obligation constitutes investment capital. Based on this claim, petitioner argues that it had investment capital in addition to its investment portfolio and that the Division improperly applied section 3-3.2(a)(1) of its regulations. Petitioner’s position is rejected because it has not established that the Wilmington debt qualifies as investment capital.

Under section 3-3.2(c)(3) of the Division’s regulations, investment capital includes qualifying corporate debt instruments. Section 3-3.2(d)(1)(iii) provides that qualifying corporate debt instruments do not include “instruments acquired by the taxpayer for services rendered or for the sale, rental or transfer of property, where the obligor is the recipient of the services or property.” The evidence in the record does not fully detail the circumstances which resulted in Wilmington’s obligation to petitioner. For instance, it is not known whether petitioner actually filed suit against Wilmington in a court of law or merely pressed its claim in the context of its business relationship with Wilmington. The circumstances under which the conversion of petitioner’s property occurred is not in the record. The only “debt instrument” in evidence is Wilmington’s letter of November 16, 1990. Based on that letter, the most reasonable conclusion that can be drawn from the known facts is that petitioner’s legal claim against Wilmington arose out of a business transaction between the two parties. Petitioner states in its brief that the

underlying transaction was not one in which petitioner agreed to be paid over time for the furnishing of goods or services and, therefore, that it was lending funds to Wilmington to which it was immediately entitled under the settlement. Wilmington's letter of November 16, 1990 states that Wilmington's debt is a refund of amounts paid by petitioner to Wilmington for goods which were damaged or converted by Wilmington. Thus, it would appear that Wilmington was paying petitioner for goods belonging to petitioner. In light of facts which tend to show that the Wilmington debt arose in the context of an ordinary business transaction involving the transfer of goods from petitioner to Wilmington, petitioner carried a heavy evidentiary burden of establishing that the Wilmington debt qualified as investment capital pursuant to section 3-3.2(d)(1)(iii) of the regulations. The weight of this burden is compounded by the fact that petitioner did not include the Wilmington debt in its computation of investment capital on corporation franchise tax returns filed for the 1991 and 1992 fiscal years. Therefore, it was incumbent upon petitioner to explain the discrepancy between its filed returns and the position it takes in this proceeding. Petitioner did not satisfy its burden of proof. Accordingly, I conclude that Wilmington's debt is not investment capital, and the Division properly treated the interest income from that debt as business income.

C. Since petitioner had no investment capital other than the short-term debt instruments in its investment portfolio, it was appropriate under the regulations for the Division to treat its income from those instruments as business income and to allocate it by petitioner's BAP. Petitioner agrees that the Division correctly applied its regulations. However, it claims that it is irrational for the Division to characterize income from its investment portfolio as business income since the facts show that the income was the product of a long-range investment program unrelated to petitioner's business activity. This argument is rejected.

By arguing that the Division's regulations are irrational as applied, petitioner is raising a constitutional claim, essentially arguing that for equal protection or due process purposes the taxation of income from its investment portfolio has no rational basis. This claim has no merit.

Through its statutory apportionment formula, New York levies a tax on corporate income earned within and without New York State. The United States Supreme Court has upheld the constitutionality of such formulas, requiring as a general principle only a "minimal connection" between the corporation's interstate activities and the taxing state, and a "rational relationship" between the income attributed to the taxing state and the intrastate values of the enterprise (*Moorman Mfg. Co. v. Bair*, 437 US 267, 272-273). The constitutional limitations on a state's taxing power were summarized by the Supreme Court in *Allied-Signal, Inc. v. Director, Div. of Taxation* (504 US 768, 772, 773):

[a]mong the limitations the Constitution sets on the power of a single State to tax the multi-state income of a nondomiciliary corporation are these: there must be "a 'minimal connection' between the interstate activities and the taxing State," *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273), and there must be a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business. 445 U.S., at 437. Under our precedents, a State need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary. E.g. *Asarco Inc. v. Idaho State Tax Commn.*, 458 U.S. 307, 317. A State may not tax a nondomiciliary corporation's income, however, if it is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise'" (*Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 224, *quoting Mobil Oil, supra*, at 442, 439).

To overcome imposition of a statutory apportionment formula, the taxpayer carries the "distinct burden of showing by 'clear and cogent evidence' that [the imposition] results in extraterritorial values being taxed" (*Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, at 221, *quoting Butler Bros. v. McColgan*, 315 US 501, 507, *quoting Norfolk & W. Ry. Co. v. State of*

North Carolina, 297 US 682, 688). Where petitioner satisfies this burden, the Division is empowered to revise the tax calculation to avoid an unconstitutional result (*Matter of British Land (Maryland), Inc.*, Tax Appeals Tribunal, September 3, 1992, *confirmed* 202 AD2d 867, 609 NYS2d 439, *rev'd* 85 NY2d 139, 623 NYS2d 772).

Pursuant to the principles summarized in *Allied-Signal*, petitioner had the burden of showing that its business and investment activities were not part of a unitary business, or, if they were, that the tax assessment bears no relationship to petitioner's activities in New York (*Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal*, 85 NY2d 139, 623 NYS2d 772). Petitioner has failed to show either.

The facts in the record do not support petitioner's primary argument that its investment and business activities were conducted as separate, discrete businesses. The facts show that petitioner's investment activities were a part of its overall corporate business. Petitioner concedes that debt instruments were purchased pursuant to petitioner's standing instructions to its portfolio managers. Apparently, petitioner (or more likely, its board of directors) developed the investment policy followed by the portfolio managers, decided which managers to hire, and made decisions regarding the distribution of income from the investment portfolio. Shareholders of the corporation received direct distributions of a portion of that income, and the remainder was reinvested. Petitioner engaged in the planning, policy formulation and decision making related to the investments, and there is no evidence in the record that suggests that these activities were not part of a unitary business conducted by petitioner. It is irrelevant that the investment portfolio was managed by unrelated third-parties, banking institutions whose business it is to manage and maintain investment portfolios. The activities of the portfolio managers are not petitioner's investment activities, and their activities do not constitute a separate and discrete business of

petitioner. As the Division notes, investments were made with profits from petitioner's multistate business activities. Excess cash from these activities contributed to the growth of the portfolio; thus, as with the operations of any unitary business, petitioner's investment and business activities are related. In short, petitioner has not carried its burden to show that its investment activities were not part of a unitary business.

Based on the fact that the investment portfolio was maintained and managed outside of New York, petitioner claims that income from the portfolio cannot be allocated to New York. If income from the investment portfolio were properly treated as investment income, as petitioner claims it should be, the fact that the portfolio was maintained and managed from outside of New York would not be a bar to imposition of tax by New York. As the Division correctly notes, the argument made by petitioner was considered in *Matter of Allied-Signal v. Commissioner of Fin.* (79 NY2d 73, 580 NYS2d 696) and rejected (*see also, Matter of Allied-Signal v. Tax Appeals Tribunal*, 229 AD2d 759, 645 NYS2d 895). The portion of a taxpayer's investment income allocated to New York State is derived by measuring the contacts of the issuers of the obligations or securities in which the taxpayer corporation invests. For each individual security or obligation invested in by the taxpayer, the investment allocation percentage is determined by reference to the issuer's BAP (Tax Law § 210[b][1]). Therefore, the site of the taxpayer's investment activities is irrelevant for allocation purposes since it is the issuer's activities which determine the IAP and provide the requisite contact with New York State (*see, Matter of Allied-Signal v. Tax Appeals Tribunal, supra*, at 898). As simply stated in *Matter of Forbes v. Dept. of Fin.* (66 NY2d 243, 496 NYS2d 394, 396), "investment income is taxable to the extent of the issuer's connection with the [State]." Since governmental authorities do not file reports or returns, the extent of their contact with the State cannot be measured by reference to the

governmental authority's BAP; therefore, investment income from government obligations is treated somewhat differently than corporate obligations. However, the basic principle set forth in *Allied-Signal* remains the same: for purposes of determining petitioner's investment income allocated to New York, neither the site of its investment activities nor the site of the activities of its portfolio managers is relevant.

Here, the Division treated debt instruments in petitioner's investment portfolio as cash on hand, and because petitioner had no other investment capital, treated that cash on hand as business capital pursuant to section 3-3.2(a)(1) of its regulations. Petitioner claims that treating its investment portfolio as a cash equivalent is unreasonable. To prove this claim under a due process or equal protection analysis, it was incumbent upon petitioner to establish that application of the regulation results in taxation of extraterritorial values. It has not carried this burden. Petitioner's reliance on *Matter of British Land (Maryland) v. Tax Appeals Tribunal* (*supra*) and *People ex rel. Sheraton v. State Tax Commn.* (15 AD2d 142, 222 NYS2d 192) is misplaced because the facts of this case are distinguishable from the facts of those cases.

In *British Land (Maryland)*, application of the statutory allocation formula resulted in taxation on 64 percent of the petitioner's gain from the sale of real property in Maryland (\$8.3 million of its overall \$13 million gain). The Court of Appeals confirmed the Tax Appeals Tribunal's finding that the petitioner's real estate activities in New York and Maryland were part of a unitary business, thus satisfying the first prerequisite of a constitutionally valid apportionment formula. The Court rejected the taxpayer's claim that "a tax on extraterritorial values can be established by showing that the taxpayer's formula-based intrastate income is many times greater than the income reflected in a separate geographical accounting" (*Matter of British Land (Maryland) v. Tax Appeals Tribunal* , *supra*, 85 NY2d 148, 623 NYS2d 777). The Court

reversed the judgement of the Appellate Division, however, on two grounds. The Court found that the factors responsible for the appreciation in value of the petitioner's Baltimore property, and so the factors giving rise to the income taxed by New York, occurred before the commencement of petitioner's activities in New York. It also found that the unitary business inventory consisted of only two properties, one in New York and one in Maryland, with the more newly-acquired New York property having a value almost three times that of the Maryland property. The Court held that the extremely marked difference in value between the two properties inevitably had a distorting effect on the application of the statutory formula. (*Matter of British Land (Maryland) v. Tax Appeals Tribunal*, *supra*.)

The relator in *People ex rel. Sheraton v. Tax Commn.* (*supra*), was a Massachusetts company that owned a hotel in Buffalo, New York. During the year in issue, it realized a large gain on the sale of a building in Boston, but it did not include that gain in its New York franchise report. The Court held that the capital gain was properly excluded from petitioner's New York entire net income base because the businesses conducted in New York and Massachusetts were unrelated and "[i]n no sense could they be regarded as a 'unitary business', for which the [statutory apportionment formula] was designed" (*People ex rel. Sheraton v. Tax Commn.*, *supra*, 222 NYS2d 194).

Here, petitioner has not shown that the income earned on its investment portfolio was attributable to factors present in other states but not present in New York. The facts show that petitioner was conducting a unitary business consisting of both its business and investment activities; therefore, as in *British Land*, the first prerequisite for apportioning the investment income to New York was met. Unlike the petitioners in *British Land* and *Sheraton*, petitioner has not shown that the investment income bears no relationship to petitioner's multistate

business enterprise or that the assessment is all out of proportion to the amount of business done by petitioner in New York. Since there is a rational relationship between the investment income and petitioner's multistate business enterprise, New York may allocate a portion of that income to New York (*see, Allied-Signal, Inc. v. Director, Div. of Taxation, supra*).

D. Petitioner's claim that the Division's regulations are invalid as applied to petitioner is rejected. This claim is premised on two arguments: (a) that the regulations are inconsistent with the plain meaning and language of the statute and (b) that it is irrational to recast its investments in short-term government and corporate obligations as cash. To prevail on its claim that the regulations are inconsistent with the statute, it was incumbent upon petitioner to show that the Division's interpretation of the statutory provisions is unreasonable (*Matter of Aetna Casualty and Surety Co. V. Tax Appeals Tribunal*, 214 AD2d 238, 633 NYS2d 226). Petitioner has not carried this burden.

As petitioner notes, there is no statutory provision which requires a taxpayer to treat short-term debt instruments (those payable on demand or within six months and one day from the date on which the debt is incurred) as cash or as a cash equivalent. The "deemed cash" provision of the regulations (20 NYCRR 3-3.2[a][1]) was adopted as part of a larger revision of the Division's regulations on investment capital which was intended to update the regulations in light of tremendous changes which took place in the financial markets in the 1980s. The regulations interpret the phrase "stocks, bonds and other securities" as used in Tax Law § 208(5) in light of the development and use of financial instruments which were unknown or not widely prevalent when the statute was adopted. The regulations attempt to treat these instruments in a manner consistent with the role they play in the investment and financial community (11 NY Reg 49 [1989]). Since short-term obligations have the liquidity of cash and for other business and

financial purposes may be considered to be cash on hand or a cash equivalent, it is not unreasonable for the Division to deem short-term debt instruments to be cash. The regulations simply view short-term debt instruments as the financial and investment markets do. Petitioner has put forth no arguments which demonstrate that it is unreasonable to treat short-term debt instruments as the equivalent of cash. In most situations, this treatment would be advantageous to the taxpayer since it would allow the taxpayer to treat such instruments as either investment capital or business capital (20 NYCRR 3-3.2[a][1]). In petitioner's case, that election was forfeited pursuant to section 3-3.2(a) of the regulations because petitioner had no other investment capital. Petitioner argues that to the extent that the regulation revokes the statutory election, it is invalid. This argument is also rejected.

The election provision allows taxpayers the maximum flexibility by allowing them to treat cash as business or investment capital, and, as petitioner asserts, there is no statutory provision which precludes a taxpayer from making the election if it has no other investment capital. Tax Law § 210(3)(b)(3), however, states that, if a taxpayer's investment allocation percentage is zero, interest received on bank accounts must be multiplied by the taxpayer's business allocation percentage. Petitioner concedes that the statute is reasonable. It is also reasonable for the Division to consider short-term debt instruments (corporate or governmental), short-term certificates of deposit and money market funds to be the functional equivalent of a bank account, which is what the regulation does. None of petitioner's arguments establish that the Division's interpretation of the statute is unreasonable or irrational.

Petitioner considers application of the statute to its situation to be absurd because the result is allegedly inconsistent with petitioner's own intention to treat its investment portfolio as investment capital. A taxpayer's subjective intention is a poor basis for deciding whether a

particular debt instrument should be treated as investment or business capital. Even if petitioner's income from the investment portfolio was not channeled into petitioner's business, and its overall investment program was long term in nature, the regulations remain reasonable.

An apportionment formula is reasonable if there is a "minimal connection" between the corporation's interstate activities and the taxing state and a "rational relationship" between the income attributed to the taxing state and the intrastate value of the enterprise (*Moorman Mfg. Co. v. Bair, supra*, 437 US 267, 272-273). Petitioner has offices and conducts business in New York, so there is more than a minimal connection between its interstate activities and New York. Petitioner's investment and business activities are part of a unitary business, so there is a rational relationship between the income attributed to New York and the intrastate value of petitioner's business enterprise. The Division's regulations allow a taxpayer to treat cash as investment or business capital, but they also cure the obvious distortion that results where a taxpayer has substantial investment capital allocable to New York and an IAP of zero.

Contrary to petitioner's arguments, the Court of Appeals decision in *Matter of Forbes v. Dept. of Fin. (supra)* supports the Division's position on this issue rather than petitioner's. In that case, the Court considered the validity of a provision of New York City's corporation franchise tax which provided the formula for calculating the IAP. At the time, Tax Law § 210 (3)(b)(former[3]) was identical to the complained of provisions of the City Administrative Code. Under the City Administrative Code the obligations of the 49 states other than New York were allocated wholly outside the City. Obligations of the Federal government and of New York State were allocated in accordance with the taxpayer's IAP. However, if the IAP was zero, income from Federal government and New York obligations was allocated based on a taxpayer's BAP. In addition, the City adopted an audit policy known as the "18% rule". Under this rule, the

auditor calculated a ratio between the value of the petitioner's investments in corporate obligations and the total value of its investments, which yielded a ratio under 2%, and then excluded the petitioner's corporate obligation from the calculation of IAP because the ratio was less than 18%.⁴ As a result, the corporate obligation went untaxed. But because the exclusion reduced the petitioner's IAP to zero, investment income from Federal obligations and bank accounts was allocated based on the petitioner's BAP of 60%, rather than its IAP of 2.38%. The Court found that the result of the City tax law was to place a greater obligation on taxpayers holding Federal obligations than those holding other obligations, thus making them less attractive investments. This result arose from the method of calculating a taxpayer's IAP. Under the former City tax law (and the former State Tax Law), the numerator of the fraction included all corporate obligations and the denominator included the total value of investment capital, excluding United States obligations and bank accounts. Since the IAP is a fraction, a smaller denominator results in a larger IAP. The Court demonstrated through a series of hypotheticals that investments in Federal obligations, rather than the obligations of the other 49 states, would result in a larger tax burden. The 18% rule compounded the disparity. As a consequence, the Court found that the City tax adversely affected Federal obligations in comparison to other obligations and invalidated the City's tax provision on this basis alone.

Significantly, the Court did not find either the City Administrative Code or the 18% rule to be irrational for due process or equal protection purposes. To the contrary, it held that a rational basis existed for both. It invalidated the statute and the discretionary adjustment under 31 USC § 3124(a) on the sole ground that they adversely affected Federal obligations in comparison to

⁴The auditor did so under the authority of Administrative Code § R46-4.0(8) which provides the Director of Finance with the authority to make discretionary adjustments to the statutory formula by excluding one or more assets from the calculation of IAP.

other obligations. (*Matter of Forbes v. Dept. of Fin.*, *supra*, 66 NY2d at 252, 496 NYS2d at 400.)

Shortly after the *Forbes* decision was issued, the Division issued a Technical Services Memorandum where it advised taxpayers that: (a) obligations of the United States were to be included in the denominator of the fraction used to determine the IAP and (b) where the taxpayer's investment allocation percentage was zero, it would no longer be required to allocate interest income from Federal paper by the taxpayer's BAP (TSB-M-86[6]C). Statutory amendments were made thereafter which codified the Division's policy into law (L 1987, ch 817, § 28). This amendment was a direct consequence of the *Forbes* decision and was intended to remove the adverse consequence resulting from treating Federal obligations differently from the obligations of the 49 states other than New York and corporate obligations. An additional consequence of the amendment was to allow investments in Federal obligations to go untaxed where the taxpayer had an investment allocation percentage of zero.⁵ This result was not required by the *Forbes* decision which only required like treatment of Federal and other obligations. The current regulatory scheme avoids disadvantageous treatment of Federal obligations by treating all government securities and qualifying corporate debt instruments alike. In addition, the regulations cure the distortion resulting from applying an IAP of zero to income from substantial investment capital.

E. The Division did not err in imposing penalties, and petitioner has not shown that it had reasonable cause for understatement of the tax due. Petitioner asserts that its reporting position was undertaken in good faith and that the allocation issue is one of first impression for petitioner.

⁵ Since no government obligations are included in the numerator of the IAP calculation, including Federal obligations in the denominator will result in an IAP of zero where the taxpayer has no other investment capital.

These assertions do not constitute reasonable cause. Section 46.1(d) of the Division's regulations describe hypothetical situations which exemplify reasonable cause for failure to report tax due. Petitioner's situation falls into none of the categories given. Section 46.1(d)(4) states:

Any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. *Ignorance of the law, however, will not be considered as a basis for reasonable cause.*

Petitioner's case for reasonable cause is nothing more than a claim of ignorance of the law. The tax asserted against petitioner was determined by application of the Division's regulations defining investment capital (20 NYCRR 3-3.2). These regulations are clear and unambiguous. They had an effective date of December 7, 1989 which is well before the beginning of petitioner's 1991 fiscal year. Petitioner has offered no reason for failing to follow the clear direction of the regulations. Petitioner states that its "tax return position was undertaken in good faith consistent with its *investment* intentions and the logic of its position in light of the nature and scope of its investment activity and New York's method of taxation (Petitioner's reply brief, p. 10; emphasis in original). If a tax position consistent with the taxpayer's own intentions and interpretation of the law were held to constitute reasonable cause, no penalty would ever be enforced.

F. The petition of Lanscot-Arlen Fabrics, Inc. is denied; the Notice of Deficiency, dated May 3, 1995 is sustained; and its claim for refund of corporation franchise taxes paid is denied.

DATED: Troy, New York
June 4, 1998

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE